14

Issues in Partnership Accounts

Learning Objectives

- After studying this unit, you will be able to:
- Understand the features of a partnership firm and the need for a Partnership Deed.
- Understand the points to be covered in a Partnership Deed regarding accounts.
- Learn the technique of maintaining Profit and Loss Appropriation Account.
- Familiarise with the two methods of maintaining Partners' Capital Accounts, namely Fixed Capital Method and Fluctuating Capital Method.
- Learn where to show interest on capital and drawings, salaries/commissions to partners etc. Also learn that drawings by partners will not appear in the Appropriation Account.
- Learn the accounting of goodwill and see when valuation of goodwill becomes essential in partnership accounts.
- Deal with change in profit sharing ratio without any change in the constitution of partnership.
- Understand the reasons for which revaluation of assets and recomputation of liabilities is required in case of admission of a new partner. Also understand the logic of revaluation of assets and recomputation of liabilities at the time of admission, retirement of a partner and death of a partner.
- Learn the treatment of balance of reserves on admission, retirement or death of a partner.
- Know how to arrive at new profit-sharing ratio after admission, retirement or death of a partner.
- Learn how to keep records if the balance due to the retiring partner is transferred to loan account.
- Understand the accounting implications if death of a partner takes place at any date during the accounting period.
- Learn to record accounting required at the time of death of partner and how to record payment of profit to the Executor of the deceased partner for part of the accounting year.

1. Definition and Features of Partnership Accounts

The Indian Partnership Act defines partnership as the relationship between persons who have agreed to share the profit or loss of a business carried on by all or any of them acting for all. Such persons are individually known as partners and they do business in the name of their firm. Generally, partners agree among themselves as regards terms and conditions on which the business of the firm will be carried on. But often they carry on business on the basis of a verbal agreement.

The essential features of partnership are:

(i) Association of two or more persons;

(ii) An agreement entered by all persons concerned;

(iii) Existence of a business;

(iv) The carrying on of business by all or any of them acting for all;

(v) Sharing of profits and losses of the business at an agreed ratio.

So a partnership is run by a mutual written agreement called *partnership deed* which may be either registered or unregistered but for the sake of settlement of future disputes among the partners, it is better to have a registered partnership deed.

The partnership deed generally details out the following clauses:

(i) Name of the firm and nature of the partnership business;

(ii) Commencement and tenure of the business;

(iii) Amount of capital to be contributed by each partner;

(iv) The ratio for sharing profit and loss of the partnership business among the partners;

(v) Arrangement of drawings by partners, making limit thereon and interest if any, to be charged on drawings;

(vi) Salary to be given to the partners;

(vii) Interest, if any, to be allowed on capital contributed by the partners;

(viii) Rent to be paid to the partners whose premises are used for the purpose of business;

(ix) Process of appropriation in case of any dispute among the partners;

(x) Procedure for maintenance of accounts and audit thereof;

(xi) Valuation of goodwill in case of admission of new partners, retirement of existing partners and death of a partner;

(xii) Procedure for settlement of partners' claims in case of retirement or death.

(xiii) Procedure for dissolution of partnership, etc.

If any situation or circumstance is not either covered in the partnership deed or adequately explained, such situation or circumstance should be settled by applying the provisions of the Partnership Act, 1932.

The partners are supposed to have the power to act in certain matters and not to have such powers in others.

In other words, unless a public notice has been given to the contrary, certain contracts entered into by a partner on behalf of the partnership, even without consulting other partners are binding and the provisions of the Act relating to the question will apply. In case of a trading firm, the implied powers of partners are the following:

(a) Buying and selling of goods;

(b) Receiving payments on behalf of the firm and giving valid recepit;

(c) Drawing cheques and drawing, accepting and endorsing bills of exchange and promissory notes in the name of the firm;

(d) Borrowing money on behalf of the firm with or without pledging the inventories-in-trade;

(e) Engaging servants for the business of the firm.

In certain cases an individual partner has no power to bind the firm. This is to say that third parties cannot bind the firm unless all the partners have agreed. These cases are :

(a) Submitting a dispute relating to the firm arbitration;

(b) Opening a bank account on behalf of the firm in the name of a partner;

(c) Compromise or relinquishment of any claim or portion of claim by the firm;

(d) Withdrawal of a suit or proceeding filed on behalf of the firm;

(e) Admission of any liability in a suit or proceedings against the firm;

(f) Acquisition of immovable property belonging to the firm;

(g) Entering into partnership on behalf of the firm.

The rights, duties and power of partners can be changed by mutual consent.

Students should remember that in the absence of any agreement to the contrary;

1. no partner has the right to a salary,
2. no interest is to be allowed on capital,
3. no interest is to be charged on the drawings,
4. interest at the rate of 6% is to be allowed on a partner's loan to the firm, and
5. profits and losses are to be shared equally.

Note : In the absence of an agreement, the interest and salary payable to a partner will be paid only if there is profit.

2. Partners' Capital and Current Accounts

From the point of view of accounting, maintenance of the partners' capital accounts and current accounts is very important. The relevant accounting transactions and events are:

- Initial contribution by partners towards capital of the firm.
- Fresh capital contributed by partners.
- Interest entitlements (if agreed in the partnership deed) on capital so contributed;
- Amount withdrawn by the partners from time to time;
- Interest liability of partners on such drawings (if agreed in the partnership deed);
- Salary to partners for services rendered to run the partnership business;
- Rent of premises let out to partnership by the partners;
- Share of profit or loss of the partnership business.

How to account for all such transactions and events in the partnership accounts should be understood properly.

There are two methods of accounting –

i) fixed capital method and

ii) fluctuating capital method.

In fixed capital method, generally initial capital contributions by the partners are credited to partners' capital accounts and all subsequent transactions and events are dealt with through current accounts, Unless a decision is taken to change it, initial capital account balance is not changed.

In fluctuating capital method, no current account is maintained. All such transactions and events are passed through capital accounts. Naturally, capital account balance of the partners fluctuates every time. So in fixed capital method a fixed capital balance is maintained over a period of time while in fluctuating capital method capital account balances fluctuate all the time.

Illustration 1

A and B start business on 1st January, 2014, with capitals of ₹ 30,000 and ₹ 20,000. According to the Partnership Deed, B is entitled to a salary of ₹ 500 per month and interest is to be allowed on capitals at 6% per annum. The remaining profits are to be distributed amongst the partners in the ratio of 5:3. During 2014 the firm earned a profit, before charging salary to B and interest on capital amounting to ₹ 25,000. During the year A withdrew ₹ 8,000 and B withdrew ₹ 10,000 for domestic purposes. Show the capital accounts of the partners following fluctuating capital method.

Solution

A's Capital Account

2014		₹	2014			₹
Dec. 31	To Cash (Drawings)	8,000	Jan. 1	By	Cash	30,000
	To Balance c/d	33,800	Dec. 31	By	Profit and Loss A/c (Interest)	1,800
				By	Profit and Loss A/c (5/8 Profit)	10,000
		41,800				41,800
			2015			
			Jan. 1	By	Balance b/d	33,800

B's Capital Account

2014		₹	2014		₹
Dec.31	To Cash (Drawings)	10,000	Jan. 1	By Cash	20,000
	To Balance c/d	23,200	Dec. 31	By Profit and Loss A/c	
				Salary	6,000
				Interest	1,200
				By Profit and Loss A/c (3/8 Profit)	6,000
		33,200			33,200
			2015		
			Jan. 1	By Balance b/d	23,200

Illustration 2

Ram and Rahim started business with capital of ₹ 50,000 and ₹ 30,000 on 1st January, 2014. Rahim is entitled to a salary of ₹ 400 per month. Interest is allowed on capitals and is charged on drawings at 6% per annum. Profits are to be distributed equally after the above noted adjustments. During the year Ram withdrew ₹ 8,000 and Rahim withdrew ₹ 10,000. The profit for the year before allowing for the terms of the Partnership Deed came to ₹ 30,000. Assuming the capitals to be fixed, prepare the Capital and Current Accounts of the partners.

Solution

Ram's Capital Account

2014		₹	2014		₹
Dec.31	To Balance c/d	50,000	Jan. 1	By Cash	50,000

			2015		
			Jan. 1	By Balance b/d	50,000

Rahim's Capital Account

2014		₹	2014		₹
Dec. 31.	To Balance c/d	30,000	Jan. 1	By Cash	30,000
			2015		
			Jan. 1	By Balance b/d	30,000

Ram's Current Account

2014		₹	2014		₹
	To Cash (Drawings)	8,000	Dec. 31	By Profit and Loss A/c	
Dec. 31	To Profit and Loss A/c			Interest	3,000
	Interest on Drawings	240		By Profit and Loss A/c	
	To Balance c/d	5,230		1/2 Profit	10,470
		13,470			13,470
			2015		
			Jan. 1	By Balance b/d	5,230

Rahim's Current Account

2014		₹	2014		₹
	To Cash (Drawings)	10,000	Dec. 31	By Profit and Loss A/c	
Dec. 31	To Profit and Loss A/c			Salary	4,800
	Interest on drawings	300		Interest	1,800
	To Balance c/d	6,770		By Profit and Loss A/c	
				1/2 Profit	10,470
		17,070			17,070
			2015		
			Jan. 1	By Balance b/d	6,770

3. Profit and Loss Appropriation Account

- Profit and Loss Appropriation Account is prepared by a partnership firm to distribute the net profit among the partners in accordance with the partnership deed.
- Any interest on drawing is added to the net profit and thereafter out of such total profit, interest on partners' capital, salaries, commission, rent etc. are distributed as per agreement.
- The balance of profit is distributed among the partners at the profit sharing ratio.
- One partner may have the right to have minimum amount of profits in a year as per terms of partnership agreement.

Net loss and Interest on Capital: Subject to contract between the partners, interest on capitals is to be provided out of profits only. Thus in case of loss, no interest is provided. But in case of insufficient profits (i.e., net profit less than the amount of interest on capital), the amount of profit is distributed in the ratio of capital as partners get profit by way of interest on capital only

Illustration 3

X, Y & Z are in partnership. Y and Z are entitled to 15% commission on net profit to be shared equally for the special service rendered by them to the partnership. However, all the partners are entitled to 8% interest on fixed capital of ₹ 5,00,000 each. The business is run at the premises of Mr. X who is further entitled to get a monthly rent of ₹ 2,000 to be adjusted against his current account. They share profits and losses equally. Net profit during the year 2014 was ₹ 7,00,000.

During the year they were discussing to change the profit sharing ratio because X could not attend to business work. Finally they decided to increase interest on capital to 12% p.a. with effect from 1-10-2014 and to change the profit sharing ratio to 1:2:2 with effect from the same date and Y and Z would not get any commission. Prepare Profit and Loss Appropriation Account.

Solution

Profit and Loss Appropriation Account

	₹	₹		₹
To Commission			By Net Profit	7,00,000
Y	39,375			
Z	39,375	78,750		
To Interest				
X	45,000			
Y	45,000			
Z	45,000	1,35,000		
To Rent-X		24,000		
To Current A/cs				
X	1,37,550			
Y	1,62,350			
Z	1,62,350	4,62,250		
		7,00,000		7,00,000

Working Notes :

(1)	*Interest*	*Jan-Sept. 2014 @ 8%* ₹	*Oct-Dec. 2014 @ 12%* ₹	*Total* ₹
	X	30,000	15,000	45,000

	Y	30,000	15,000	45,000
	Z	30,000	15,000	45,000
		90,000	45,000	1,35,000

(2) Commission

¾ of (15% on ₹ 7,00,000) = ₹ 78,750

(3)	*Share of Profit*	*Jan-Sept. 2014* ₹	*Oct-Dec. 2014* ₹	*Total* ₹
	Profit for the period	5,25,000	1,75,000	7,00,000
	Less: Commission	(78,750)	-	(78,750)
	Less : Interest	(90,000)	(45,000)	(1,35,000)
	Less : Rent	(18,000)	(6,000)	(24,000)
	Profit available for distribution in the profit sharing ratio	3,38,250	1,24,000	4,62,250
	X	1,12,750	24,800	1,37,550
	Y	1,12,750	49,600	1,62,350
	Z	1,12,750	49,600	1,62,350

4. Treatment of Goodwill in Partnership Accounts

Goodwill is the value of reputation of a firm in respect of profits expected in future over and above the normal rate of profits. The implication of the above is that there is always a certain normal rate of profits earned by similar firms in the same locality. The excess profit earned by a firm may be due to its locational advantage, better customer service, possession of a unique patent right, personal reputation of the partners or for similar other reasons. The necessity for valuation of goodwill in a firm arises in the following cases:

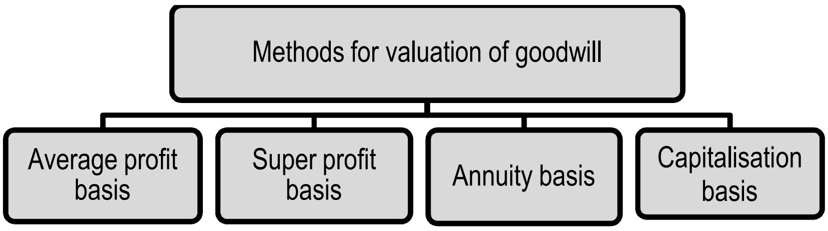
(a) When the profit sharing ratio amongst the partners is changed;

(b) When a new partner is admitted;

(c) When a partner retires or dies, and

(d) When the business is dissolved or sold.

There are four methods for valuation of goodwill, viz:



4.1 Methods for Goodwill Valuation

1. Average Profit Basis: In this case the profits of the past few years are averaged and adjusted for any expected change in future. For averaging the past profit, either simple average or weighted average may be employed depending upon the circumstances. If there exists clear increasing or decreasing trend of profits, it is better to give more weight to the profits of the recent years than those of earlier years. But, if there is no clear trend of profit, it is better to go by simple average.

Let us suppose profits of a partnership firm for the last five years were ₹ 30,000, ₹ 40,000, ₹ 50,000, ₹ 60,000 and ₹ 70,000. In this case, a clear increasing trend is noticed and therefore, average profit may be arrived at by assigning appropriate weight as shown below:

Year	*Profit*	*Weight*	*Weighted Profit*
	₹		₹
1	30,000	1	30,000
2	40,000	2	80,000
3	50,000	3	1,50,000
4	60,000	4	2,40,000
5	70,000	5	3,50,000
		15	8,50,000

$$\text{So Weighted Average Profit} = \frac{₹\ 8,50,000}{15} = ₹\ 56,667$$

If goodwill is valued at three years' purchase of profit, then in this case the value of goodwill is ₹ 56,667 × 3 = ₹ 1,70,000.

However, if any such trend is not visible from the figures of past profits, then one should take simple average profit and calculate goodwill accordingly. Let us suppose, profits of a partnership firm for five years were ₹ 30,000, ₹ 25,000, ₹ 20,000, ₹ 30,000 and ₹ 28,000. In this case, there is no clear increasing or decreasing trend of profit. So average profit comes to ₹ 26,600 (arrived at by taking simple average). If the goodwill is valued by taking three years' purchase of profit, value of goodwill becomes ₹ 79,800.

2. Super Profit Basis: In case of average profit basis, goodwill is calculated on the basis of average profit multiplied by certain number of years. The implication is that such profit will be maintained for so many numbers of years and the partner(s) who gains in terms of profit sharing ratio should contribute for such gains in profit to the partners who make the sacrifice. On the other hand, super profit means, excess profit that can be earned by a firm over and above the normal profit usually earned by similar firms under similar circumstances. Under this method, the partner who gains in terms of profit sharing ratio has to contribute only for excess profit because he can earn normal profit by joining any partnership. Under super profit method, what excess profit a partnership firm can earn is to be determined first. The steps to be followed are given below:

(a) Identify the capital employed by the partnership firm;

(b) Identify the average profit earned by the partnership firm based on past few years' figures;

(c) Determine normal rate of return prevailing in the locality for similar firms;

(d) Apply normal rate of return on capital employed to arrive at normal profit;

(e) Deduct normal profit from the average profit of the firm. If the average profit of the firm is more than the normal profit, there exists super profit and goodwill.

Let us suppose total capital employed by a partnership firm was ₹ 1,00,000 and its average profit was ₹ 25,000. Normal rate of return is 22% in case of similar firms working under similar conditions. So normal profit is ₹ 22,000 and average profit is ₹ 25,000. The partnership firm earns ₹ 3,000 super profit.

Goodwill is generally valued by multiplying the amount of super profit by certain number of years depending upon the expectation about the maintenance of such super profit in future. If it is expected that the super profit can be maintained for another five years in future, then value of goodwill may be taken as ₹ 3,000 × 5 = ₹ 15,000.

3. Annuity Method: In the super profit method explained above, time value of money is not considered. Although it was expected that super profit would be earned in five future years, still no devaluation was done on the value of money for the time difference. In fact when money will be received in different points of time, its values should be different depending upon the rate of interest. If 15% rate of interest is considered appropriate, then discounted value of super profit to be earned in different future years will be as follows:

Year	*Super Profit*	*Discount Factor @ 15%*	*Discounted value of Super Profit*
	₹	₹	₹
1	3,000	.8696	2,608.80
2	3,000	.7561	2,268.30
3	3,000	.6575	1,972.50
4	3,000	.5718	1,715.40
5	3,000	.4972	1,491.60
			10,056.60

So under the annuity method, discounted value of super profit becomes ₹ 10,056.60 and not ₹ 15,000 as was done under super profit method.

The word annuity is used to mean identical annual amount of super profit, so for discounting it is possible to refer to annuity table. As per the annuity table, present value of Re.1 to be received at the end of each year for 5 years @ 15% interest p.a. is 3.3522. So value of goodwill under annuity method is ₹ 3000 × 3.3522 = ₹ 10,056.60.

4. Capitalisation Basis: Under this basis value of whole business is determined applying normal rate of return. If such value (arrived at by applying normal rate of return) is higher than the capital employed in the business, then the difference is goodwill. The steps to be followed

under this method are given below:

(a) Determine the normal rate of return,

(b) Find out the average profit of the partnership firm for which goodwill is to be determined,

(c) Determine the capital employed by the partnership firm for which goodwill is to be determined,

(d) Find out normal value of the business by dividing average profit by normal rate of return.

(e) Deduct average capital employed from the normal value of the business to arrive at goodwill.

Let us suppose capital employed by a partnership firm is ₹ 1,00,000, its average profit is ₹ 20,000, Normal rate of return is 15%.

Normal Value of business = $\frac{20,000}{15}$ x 100 = ₹ 1,33,333

Value of goodwill = ₹ 1,33,333 – ₹ 1,00,000 = ₹ 33,333

Illustration 4

Lee and Lawson are in equal partnership. They agreed to take Hicks as one-fourth partner. For this it was decided to find out the value of goodwill. M/s Lee and Lawson earned profits during 2011-2014 as follows:

Year	*Profit*
	₹
2011	*1,20,000*
2012	*1,25,000*
2013	*1,30,000*
2014	*1,50,000*

On 31.12.2014 capital employed in M/s Lee and Lawson was ₹ 5,00,000. Rate of normal profit is 20%.

Find out the value of goodwill following various methods.

Solution

Average Profit:

Year	*Profit (₹)*	*Weight*	*Weighted Profit (₹)*
2011	1,20,000	1	1,20,000
2012	1,25,000	2	2,50,000
2013	1,30,000	3	3,90,000
2014	1,50,000	4	6,00,000
		10	13,60,000

Weighted Average Profit = ₹ 1,36,000

Method (1): Average Profit Basis

Assumption: Goodwill is valued at 3 year's purchase

Value of Goodwill: ₹ 1,36,000 × 3 = ₹ 4,08,000

Method (2): Super Profit Basis

	₹
Average Profit	1,36,000
Normal Profit (20% on ₹ 5,00,000)	1,00,000
	36,000

Assumption: Goodwill is valued at 3 years purchase.

Value of Goodwill: ₹ 36,000 × 3 = ₹ 1,08,000

Method (3): Annuity Basis

Assumptions:

(a) Interest rate is equivalent to normal profit rate i.e. 20% p.a.

(b) Goodwill is valued at 3 years' purchases

Valuation of Goodwill: ₹ 36,000 × 2.1065 (Annuity factor at 20% for 3 years) = ₹ 75,834

Method (4): Capitalisation Basis

Normal Value of Capital employed: ₹ 1,36,000 x 100/ 20	=	₹ 6,80,000
Capital Employed in M/s Lee and Lawson	=	₹ 5,00,000
Goodwill	=	₹ 1,80,000

4.2 Accounting Treatment

Para 16 of AS 10 'Accounting for Fixed Assets' states that goodwill can be recorded in the books only when some consideration in money or money's worth has been paid for it.

Para 35 of AS 26 'Intangible Assets' also states that internally generated goodwill* should not be recognized as an asset. Internally generated (self generated) goodwill is not recognized as an asset because it is not an identifiable resource controlled by the enterprise that can be measured reliably at cost.

Therefore, only purchased goodwill should be recorded in the books.

In case of admission/retirement/death of a partner or in case of change in profit sharing ratio

* The enterprise, while doing business, develops goodwill over a period of time. Goodwill generated in the process of doing business is called internally generated goodwill.

among partners, goodwill cannot be raised in the books of the firm because no consideration in money or money's worth' is paid for it. If any partner brings any premium over and above his capital contribution at the time of his admission, such premium should be distributed to other existing partners.

Sometimes at the time of any change in the constitution of the firm (by way of admission/ retirement/death/change in profit sharing ratio) goodwill of the firm is evaluated. In that situation the value of the goodwill should not be brought to books since it is inherent goodwill. Rather the value of goodwill should be adjusted through partners' capital accounts.

Accounting treatment of goodwill in case of admission of a partner

When a new partner is admitted in the firm, the value of evaluated goodwill is adjusted through concerned partners' capital accounts. The treatment is explained through following examples:

Example 1

A and B are equal partners. They wanted to take C as third partner and for this purpose goodwill was valued at ₹ 1,20,000. The journal entry for adjustment of value of goodwill through partners' capital accounts will be:

C's Capital A/c	Dr.	₹ 40,000	
To A's Capital A/c			₹ 20,000
To B's Capital A/c			₹ 20,000
(Adjustment for goodwill)			

The net effect in partner's capital accounts is shown on the basis of profit sacrificing ratio (Difference between old profit sharing ratio and new profit sharing ratio):

A $= \frac{1}{6} \times$ ₹ 1,20,000 = ₹ 20,000(Cr.)

B $= \frac{1}{6} \times$ ₹ 1,20,000 = ₹ 20,000(Cr.)

C $= \frac{2}{6} \times$ ₹ 1,20,000= ₹ 40,000(Dr.)

Example 2

A and B are equal partners. They wanted to admit C as 1/6th partner who brought ₹ 60,000 as goodwill. The new profit sharing ratio is 3:2:1. Profit sacrificing ratio is to be computed as follows:

Partners	*Old share*	–	*New share*	=	*Share sacrificed*	*Share gained*
A	$\frac{1}{2}$	–	$\frac{1}{2}$	=	0	
B	$\frac{1}{2}$	–	$\frac{2}{6}$	=	$\frac{1}{6}$	
C			$\frac{1}{6}$			$\frac{1}{6}$

So the entire goodwill should be credited to B's Capital A/c.

Cash A/c	Dr.	₹ 60,000	
To B's Capital A/c			₹ 60,000
(Goodwill brought in by C credited to B's Capital A/c in full)			

Accounting treatment of goodwill in case of change in the profit sharing ratio

In case of change in profit sharing ratio, the value of goodwill should be determined and preferably adjusted through capital accounts of the partners on the basis of profit sacrificing ratio or gaining ratio.

Example 3

A, B and C are equal partners. They wanted to change the profit sharing ratio into 4:3:2. The goodwill was valued as ₹ 90,000. Make the necessary journal entry.

Solution

Journal Entry

	₹	₹
A's Capital Dr.	10,000	
To C's Capital A/c		10,000
(Being adjusting entry passed for change in profit ratio for ₹10,000 (1/9 x 90,000)		

In this case, due to change in profit sharing ratio:

A's gain is = 4/9 less 1/3= 1/9

B's gain is = 1/3 less 1/3= 0

C's loss is = 1/3 less 2/9= 1/9

So, A should compensate C to the extent of 1/9th of goodwill i.e.

₹ 90,000 × 1/9 = ₹ 10,000

Example 4

A, B and C are in partnership sharing profits and losses in the ratio of 4:3:3. They decided to change the profit sharing ratio to 7:7:6. Goodwill of the firm is valued at ₹ 20,000. Calculate the sacrifice/gain by the partners and make the necessary journal entry.

Solution

Partners	*New share*		*Old share*	*Difference*	
				Sacrifice	*Gain*
A	$\frac{7}{20}$	–	$\frac{4}{10}$	$\frac{1}{20}$	
B	$\frac{7}{20}$	–	$\frac{3}{10}$		$\frac{1}{20}$
C	$\frac{6}{20}$	–	$\frac{3}{10}$	-	-

Thus, B gained 1/20th share while A sacrificed 1/20th share. For C there was no loss no gain.

Journal Entry

B's Capital A/c	Dr.	1,000	
To A's Capital A/c			1,000
(Being adjusting entry passed for change in profit sharing ratio for ₹1,000 (1/20 x 20,000)			

Example 5

A, B, C and D are in partnership sharing profits and losses equally. They mutually agreed to change the profit sharing ratio to 3:3:2:2.

A gains by $\frac{3}{10} - \frac{1}{4} = \frac{1}{20}$

B gains by $\frac{3}{10} - \frac{1}{4} = \frac{1}{20}$

C losses by $\frac{1}{4} - \frac{2}{10} = \frac{1}{20}$

D losses by $\frac{1}{4} - \frac{2}{10} = \frac{1}{20}$

So, if goodwill is valued at ₹ 20,000, A and B should pay @ ₹ 1,000 each as (i.e., ₹ 20,000 × 1/20) compensation to C and D respectively for their sacrifice.

Journal Entry

		₹	₹
A's Capital Account	Dr.	1,000	
B's Capital Account	Dr.	1,000	

To C's Capital Account		1,000
To D's Capital Account		1,000

It is only when there is amalgamation, conversion or sale of partnership firms, the question of recording goodwill will arise. If an existing partnership firm acquires another firm, and if the purchase consideration exceeds the net assets acquired, the difference will be shown as goodwill in the books of the transferee firm.

Accounting treatment of goodwill in case of retirement or death of a partner

In case of retirement of a partner, the continuing partners will gain in terms of profit sharing ratio. Therefore they have to pay to retiring partner for his share of goodwill in the firm in the gaining ratio.

Similarly, in case of death of the partner, the continuing partners should bear the share of goodwill due to the heirs of the deceased partner. For this purpose, the goodwill is valued on the date of the retirement of death and adjusted through the capital accounts of the partners.

Example 6

A, B and C are equal partners. C wanted to retire for which value of goodwill is considered as ₹ 90,000. The necessary journal entry will be

A's Capital A/c	Dr.	₹ 15,000	
B's Capital A/c	Dr.	₹ 15,000	
To C's Capital A/c			₹ 30,000
(C's share of goodwill adjusted to existing partners' capital accounts in profit gaining ratio)			

Illustration 5

Wise, Clever and Dull were trading in partnership sharing profits and losses 4:3:3 respectively. The accounts of the firm are made up to 31st December every year.

The partnership provided, inter alia, that:

On the death of a partner the goodwill was to be valued at three years' purchase of average profits of the three years upto the date of the death after deducting interest @ 8 per cent on capital employed and a fair remuneration of each partner. The profits are assumed to be earned evenly throughout the year.

On 30th June, 2014, Wise died and it was agreed on his death to adjust goodwill in the capital accounts without showing any amount of goodwill in the Balance Sheet.

It was agreed for the purpose of valuation of goodwill that the fair remuneration for work done by each partner would be ₹ 15,000 per annum and that the capital employed would be ₹ 1,56,000. Clever and Dull were to continue the partnership, sharing profits and losses equally after the death of Wise.

The following were the amounts of profits of earlier years before charging interest on capital employed.

	₹
2011	*67,200*
2012	*75,600*
2013	*72,000*
2014	*62,400*

You are requested to compute the value of goodwill and show the adjustment thereof in the books of the firm.

Solution

Computation of the value of goodwill:

(i)	Average Profit for three years, ending 30th June; before death:		
	Year ending 30th June, 2012 :	₹	₹
	1/2 of 2011 profits	33,600	
	1/2 of 2012 profits	37,800	71,400
	Year ending 30th June, 2013 :		
	1/2 of 2012 profits	37,800	
	1/2 of 2013 profits	36,000	73,800
	Year ending 30th June, 2014 :		
	1/2 of 2013 profits	36,000	
	1/2 of 2014 profits	31,200	67,200
	Total		2,12,400
	Average		70,800
(ii)	Super Profit :		₹
	Average profits earned		70,800
	Less : Partner's remuneration	45,000	
	Less : 8% on capital employed	12,480	(57,480)
			13,320
	Super Profits		
(iii)	Goodwill @ three years' purchase (13,320 x 3)		39,960

Adjustment entries for Goodwill

Journal Entries

		Dr. ₹	Cr. ₹
Clever's Capital Account	Dr.	7,992	
Dull's Capital Account	Dr.	7,992	
To Wise's Capital Account			15,984
(Being Wise's share of goodwill adjusted in the capital accounts of partners on the death of Mr. Wise in their gaining ratio.)			

Illustration 6

Vasudevan, Sunderarajan and Agrawal are in partnership sharing profit and losses at the ratio of 2:5:3. The Balance Sheet of the partnership as on 31.12.2014 was as follows:

Balance Sheet of M/s Vasudevan, Sunderarajan & Agrawal

Liabilities	₹	*Assets*	₹
Capital A/cs		*Sundry fixed assets*	*5,00,000*
Vasudevan	*85,000*	*Inventory*	*1,00,000*
Sunderarajan	*3,15,000*	*Trade receivables*	*50,000*
Agrawal	*2,25,000*	*Bank*	*5,000*
Trade payables	*30,000*		
	6,55,000		*6,55,000*

The partnership earned profit ₹ 2,00,000 in 2014 and the partners withdrew ₹ 1,50,000 during the year. Normal rate of return 30%.

Find out the value of goodwill on the basis of 5 years' purchase of super profit. For this purpose calculate super profit using average capital employed.

Solution

Valuation of Goodwill:		₹
(1)	*Average Capital Employed*	
	Total Assets *less* Trade receivables as on 31.12.2014	6,25,000
	Add : 1/2 of the amount withdrawn by partners	75,000
		7,00,000
	Less : 1/2 of the profit earned in 2014	(1,00,000)
		6,00,000

(2)	*Super Profit :*	
	Profit of M/s Vasudevan, Sunderarajan & Agrawal	2,00,000
	Normal profit @ 30% on ₹ 6,00,000	1,80,000
	Super Profit	20,000
(3)	*Value of Goodwill*	
	5 Years' Purchase of Super profit (₹ 20,000 × 5) = ₹ 1,00,000	

5. Change in Profit Sharing Ratio

Sometimes, change in profit sharing ratio takes place without any change in the number of patners (i.e. admission, retirement or death) of the firm.

When such a change takes place, one or more partners purchase interest in the business from the other partner(s). Therefore, the aggregate amount of gain by one or more partner(s) is equal to the aggregate amount of sacrifices made by the other partner(s). The required adjustments in regard to the profit-sharing ratio, revaluation of assets and liabilities, treatment of goodwill or reserves or partners' capitals are same as what is done in case of admission or retirement or death of a partner.

The only exception is that neither a partner is coming into the business nor a partner is going out. Sometimes a single entry is passed through partners' capital accounts in gaining/sacrificing ratio, when such changes are not to be incorporated in the balance sheet, as is passed for adjustment of goodwill.

Illustration 7

P, Q and R are partners sharing profits and losses in the ratio of 3:2:1. The goodwill of the firm is valued at ₹ 12,000. They have decided to change the profit-sharing ratio to 2:2:1. Pass necessary Journal Entries.

Solution

Journal Entries Dr. Cr.

Date	*Particulars*		₹	₹
	Q's Capital A/c (Refer Working Note)	Dr.	800	
	R's Capital A/c	Dr.	400	
	To P's Capital A/c			1,200
	(Being the adjustment for goodwill through the Partners' Capital Accounts)			

Working Note:

Calculation of share of sacrifice/gain

	P	*Q*	*R*
Old ratio (3:2:1)	$\frac{3}{6}$	$\frac{2}{6}$	$\frac{1}{6}$
New ratio (2:2:1)	$\frac{2}{5}$	$\frac{2}{5}$	$\frac{1}{5}$
	(Sacrifice) $\frac{1}{10}$	(Gain) $\frac{2}{30}$	(Gain) $\frac{1}{30}$
	12,000 x 1/10	12,000 x 2/30	12,000 x 1/30

Illustration 8

The following is the Balance sheet of Anil and Bimal, who are equal partners as on 31.12.2014:

Liabilities		₹	*Assets*	₹
Capital Accounts:	Anil	12,000	Sundry Assets	28,000
	Bimal	6,000		
Reserves		6,000		
Account payables		4,000		
		28,000		28,000

From 1.1.2015, the partners decided to share profits and losses in the ratio of 2:1. For this purpose, the goodwill of the firm is valued at ₹ 6,000 which will not be shown in the Balance Sheet.

Pass necessary Journal Entries and re-draft the Balance Sheet.

Solution

In the books of the firm

Journal Entry

Particulars		*Dr.* ₹	*Cr.* ₹
Reserves A/c	Dr.	6,000	
To Anil's Capital A/c			3,000
To Bimal's Capital A/c			3,000
(Being reserve transferred to the Partners' Capital Accounts in the old ratio before change in the constitution)			

Anil's Capital A/c (Refer W.N.) To Bimal's Capital A/c (Being the adjustment for goodwill made through the Partners' Capital Accounts)	1,000	 1,000

Balance Sheet of Anil and Bimal as at 1.1.2015

Liabilities	₹	*Assets*	₹
Capital Accounts:		Sundry Assets	28,000
Anil: ₹ (12,000+3,000-1,000)	14,000		
Bimal: ₹ (6,000+3,000+1,000)	10,000		
Account Payables	4,000		
	28,000		28,000

Working Note:

Calculation of share of sacrifice/gain

	Anil	Bimal
Old ratio (1:1)	$\frac{1}{2}$	$\frac{1}{2}$
New ratio (2:1)	$\frac{2}{3}$	$\frac{1}{3}$
	(Gain) $\frac{1}{6}$	(Sacrifice) $\frac{1}{6}$
	6,000 x 1/6	6,000 x 1/6

Illustration 9

Any and Many are partners sharing profits as to ¾ and ¼ and their capitals are ₹ 90,000 and ₹ 30,000 respectively. It is decided that with effect from 1st April, 2015 the profit-sharing ratio will be: Any 5/8 and Many 3/8. The Deed states that goodwill is to be valued at 2 years' purchase of three years' profits and capitals of the two partners should be proportionate to the profit-sharing ratio. The profits for the years ended 31st March, 2013, 31st March, 2014 and 31st March, 2015 were ₹ 42,000, ₹ 39,000 and ₹ 45,000 respectively. Make necessary journal entries.

Solution

		₹
Value of Goodwill: Total profits for 3 years -	2012-13	42,000
	2013-14	39,000
	2014-15	45,000
	Total	1,26,000

Average profit		42,000
Goodwill at 2 years' purchase		84,000

Calculation of share of sacrifice/gain

	Any	Many
Old ratio (3:1)	$\frac{3}{4}$	$\frac{1}{4}$
New ratio (5:3)	$\frac{5}{8}$	$\frac{3}{8}$
	(Sacrifice) $\frac{1}{8}$	(Gain) $\frac{1}{8}$
	84,000 x 1/8 = 10,500	84,000 x 1/8=10,500

New capital required after the change in ratio-

		₹
Total Capital	(90,000 + 30,000)	1,20,000
Any's capital	1,20,000 x 5/8	75,000
Many's capital	1,20,000 x 3/8	45,000

Journal Entries

		₹	₹
Many's Capital Account	Dr.	10,500	
To Any's Capital Account			10,500
[The value of 1/8 share of goodwill (total value ₹ 84,000) which Many acquires from Any]			
Bank Account	Dr.	25,500	
To Many's Capital Account			25,500
[The sum required to make up Many's capital upto ₹ 45,000 after the debit of ₹ 10,500, i.e., ₹ 45,000 – (30,000 – 10,500)]			
Any's Capital Account	Dr.	25,500	
To Bank Account			25,500
[The sum to be returned to Any to bring his capital down to ₹ 75,000 i.e., ₹ (90,000 + 10,500 – 75,000)]			

6. Admission of a Partner

When a new partner is admitted into the partnership, new profit sharing ratio and sacrificing ratio of old partners is calculated, assets are revalued and liabilities are reassessed. A Revaluation Account (Profit and Loss Adjustment Account) is opened for that purpose.

This account is debited with all reduction in the value of assets and increase in liabilities. The difference in two sides of the account will show profit or loss. This is transferred to the Capital Accounts of old partners in the old profit sharing ratio, The entries to be passed are :

1. Revaluation Account	Dr.	
To the assets (Individually which show a decrease)		with the reduction in the value of the assets.
To the Liabilities (Individually which have to be increased.)		with the increase in the liabilities.
2. Assets Account (Individually)	Dr.	with the increase in the value of assets.
Liabilities Account (Individually)		
To Revaluation Account		with the reduction in the amount of liabilities
3. Revaluation Account	Dr.	with the profit in the old profit
To Capital A/cs of the old partners		sharing ratio.
or,		
Capital A/cs of the old partners	Dr.	with the loss in old profit sharing
To Revaluation Account		ratio.

As a result of the above entries, the capital account balances of the old partners will change and the assets and liabilities will have to be adjusted to their proper values. They will now appear in the Balance Sheet at revised figures.

Alternatively, the partners may agree that revalued figures will not be shown in the Balance Sheet. Assets and liabilities would appear in the Balance Sheet at their old values. For this one additional entry is necessary.

Capital A/cs	Dr.	With the amount of revaluation
(of all partners including newly admitted partner)		profit in the new profit sharing ratio.
To Revaluation A/c		
Or		
Revaluation A/c	Dr.	With the amount of revaluation loss
To Capital A/cs		in the new profit sharing ratio.
(of all partners including newly admitted partners)		

In this case entries 1 and 2 are not required.

Whenever a new partner is admitted, any reserve etc. which may be lying in the Balance

Sheet should be transferred to the Capital Accounts of the old partners in the old profit sharing ratio. (In examination problems, it should be done even if there are no instructions on this point).

Illustration 10

Messers Dalal, Banerji and Mallick is a firm sharing profits and losses in the ratio 2:2:1. Their Balance Sheet as on 31st March, 2015 is as below :

Liabilities		*₹*	*Assets*	*₹*
Trade Payables		*12,850*	*Land and Buildings*	*25,000*
Outstanding liabilities		*1,500*	*Furniture*	*6,500*
General reserve		*6,500*	*Inventory*	*11,750*
Capital Account :			*Trade Receivable*	*5,500*
Mr. Dalal	*12,000*		*Cash in hand*	*140*
Mr. Banerji	*12,000*		*Cash at bank*	*960*
Mr. Malick	*5,000*	*29,000*		
		49,850		*49,850*

The partners have agreed to take Mr. Mistri as a parner with effect from 1st April, 2015 on the following terms :

(1) Mr. Mistri shall bring 5,000 towards his capital.

(2) The value of Inventory should be increased by ₹ 2,500 and Furniture should be depreciated by 10%.

(3) Provision for bad and doubtful debts should be made at 10% of the trade receivables.

(4) The value of land and buildings should be enhanced by 20% and the value of the goodwill be fixed at ₹ 15,000.

(5) The value of the goodwill be fixed at ₹ 15,000.

(6) General Reserve will be transferred to the partner's Capital Accounts.

(7) The new profit sharing ratio shall be : Mr. Dalal 5/15, Mr. Banerji 5/15,Mr. Mallick 3/15 and Mr. Mistri 2/15.

(8) The goodwill account shall be written back to the Partner's accounts in accordance with the new profit sharing proportion.

The outstanding liabilities include ₹ 1,000 due to Mr. Sen which has been paid by Mr. Dalal. Necessary entries were not made in the books.

Prepare (i) Revaluation Account, and (ii) The Capital Accounts of the partners, and (iii) the Balance Sheet of the firm as newly constituted (Journal entries are not required)

Solution

Revaluation Account

2015			₹	2015		₹
April1	To Provision for bad and doubtful debts		550	April 1	By Inventory	2,500
"	To Furniture and fittings		650	"	By Land and Building	5,000
	To Capital A/cs					
"	Profit on revaluation transferred					
	Dalal	2,520				
	Banerji	2,520				
	Mallick	1,260	6,300			
			7,500			7,500

Capital Accounts of Partners

Particulars	Dalal	Banerji	Mallick	Mistri	Particulars	Dalal	Benerji	Mallick	Mistri
	₹	₹	₹	₹		₹	₹	₹	₹
To Dalal & Benerjii	–	–	–	2,000	By Balance b/d	12,000	12,000	5,000	–
To Balance c/d	19,120	18,120	7,560	3,000	By General Reserve	2,600	2,600	1,300	–
					By Cash	–	–	–	5,000
					By Mistri*	1,000	1,000	–	–
					By Out-standing Liabilities	1,000	-	-	–
					By Revaluation A/c	2,520	2,520	1,260	–
	19,120	18,120	7,560	5,000		19,120	18,120	7,560	5,000

Balance Sheet of M/s Dalal, Banerji, Mallick and Mistri as on 1-4-2015

Liabilities		₹	Assets		₹
Trade payables		12,850	Land and Buildings		30,000
Outstanding Liabilities		500	Furniture		5,850
Capital Accounts of			Inventory		14,250

* Goodwill adjustment for Mistri's share of goodwill through Dalal and Banerji in their sacrificing ratio.

partners :					
Mr. Dalal	19,120		Trade Receivables	5,500	
Mr. Banerji	18,120		*Less:* Provision	550	4,950
Mr. Mallick	7,560		Cash in hand		140
Mr. Mistri	3,000	47,800	Cash at Bank		5,960
		61,150			61,150

6.1 Proportionate capital and goodwill inference

'Proportionate Capital' means Capital Account balances of partners in accordance with the profit sharing ratio. In other words, ratio of Capital Account balances is equal to profit sharing ratio. Proportionate capital is maintained generally following 'fixed capital method'.

For example, A and B are in partnership, sharing profit or loss at the ratio of 3:2. If total capital is ₹ 1,00,000, A should contribute ₹ 1,00,000 × 3/5 *i.e.,*₹ 60,000 and B should contribute ₹ 1,00,000 × 2/5 *i.e.,* ₹ 40,000.

The question of inferring goodwill arises only in case of proportionate capital. If the newly admitted partner brings capital more than what is required as per profit sharing ratio, then it is to be presumed that he has contributed the excess for goodwill. For example, A and B are in partnership who contributed proportionate capital of ₹ 60,000 and ₹ 40,000. Now they want to admit C giving him 1/5th share for which C agrees to bring ₹ 30,000. Since total capital is ₹ 1,00,000, C should contribute ₹ 20,000 (₹ 1,00,000 × 1/5) for 1/5th share. Instead he agrees to pay ₹ 30,000. So for 1/5th share he is paying ₹ 10,000, for goodwill. Thus total value of goodwill is ₹ 10,000 × 5 *i.e.,* ₹ 50,000.

Illustration 11

A and B are in partnership sharing profits and losses equally. The Balance Sheet of M/s A and B as on 31-12-14 was as follows :

Liabilities	*₹*	*Assets*	*₹*
Capital A/cs :		*Sundry Fixed Assets*	*60,000*
A	*45,000*	*Inventory*	*30,000*
B	*45,000*	*Bank*	*20,000*
Trade Payables	*20,000*		
	1,10,000		*1,10,000*

On 1-1-15 they agreed to take C as 1/3rd partner to increase the capital base to ₹ 1,35,000. C agrees to pay ₹ 60,000. Show the necessary journal entries, Partners' Capital A/cs and Balance Sheet as on 1-1-15.

Solution

In the Books of M/s A, B and C
Journal Entries

		₹	₹
Bank A/c	Dr.	60,000	
To C's Capital A/c			60,000
(Cash brought in by C for 1/3rd share)			
C's Capital A/c	Dr.	15,000	
To A's Capital A/c			7,500
To B's Capital A/c			7,500
(Inferred value of goodwill adjusted in the books through capital accounts)			
A's Capital A/c	Dr.	7,500	
B's Capital A/c	Dr.	7,500	
To Bank			15,000
[To keep capital intact by ₹ 1,35,000, excess capital (due to goodwill adjustment) withdrawn]			

Working Notes :

(1) Old profit sharing ratio - 1:1

(2) New profit sharing ratio - 1:1:1

(3) C's share of Capital = ₹ 1,35,000 $\times \frac{1}{3}$ = ₹ 45,000

(4) Goodwill : ₹ 60,000 — ₹ 45,000 = ₹ 15,000 for 1/3rd share.

Total Goodwill : ₹ 15,000 $\times$ 3 = ₹ 45,000

Partner's Capital Accounts

Dr. *Cr.*

Particulars	*A*	*B*	*C*	*Particulars*	*A*	*B*	*C*
	₹	₹	₹		₹	₹	₹
To A & B	-	-	15,000	By Balance b/d	45,000	45,000	-
To Bank	7,500	7,500	-	By Bank	-	-	60,000
To Balance c/d	45,000	45,000	45,000	By C	7,500	7,500	-
	52,500	52,500	60,000		52,500	52,500	60,000

Balance Sheet of M/s A, B & C as on 1-1-2015

Liabilities		₹	*Assets*	₹
Capital A/cs :			Sundry Fixed Assets	60,000
A	45,000		Inventory	30,000
B	45,000		Bank	65,000
C	45,000	1,35,000		
Trade Payables		20,000		
		1,55,000		1,55,000

7. Retirement of a Partner

- On retirement of a partner, it is required to revalue assets and liabilities and to calculate new profit sharing and sacrificing/gaining ratios of the existing partners just as in the case of admission of a partner.
- If there is revaluation profit, then such profit should be distributed amongst the existing partners including the retiring partner at the existing profit sharing ratio.
- If there is loss on revaluation such is also to be distributed to all the partners including the retiring partner at the existing profit sharing ratio.
- To arrive at profit or loss on revaluation of assets and liabilities, a Revaluation Account or Profit and Loss Adjustment Account is opened.
- Revaluation Account or Profit and Loss Adjustment Account is closed automatically by transfer of profit or loss balance to the Partners' Capital Accounts.
- If it is decided that revalued figures of assets and liabilities will not appear in the balance sheet of the continuing partners, then a journal entry should be passed only counting the amount payable or chargeable to the retiring partner which the continuing partners will share at the ratio of gain.
- In the first instance, the journal entry for distribution of profit or loss on revaluation which will appear in the balance sheet also is as follows :

  Revaluation A/c Dr.
  To Partners' Capital A/c
  (For profit on revaluation)

  Or,

  Partners' Capital A/c Dr.
  To Revaluation A/c
  (For loss on revaluation)

Now let us see how to deal with a situation where revaluation profit will not appear in the Balance Sheet.

If A, B & C share profits and losses equally and there is a revaluation profit of ₹ 30,000 calculated on A's retirement, then ₹ 10,000 becomes due to A which is to be borne by B and C equally. So the journal entry will be as follows :

		₹	₹
B's Capital A/c	Dr.	5,000	
C's Capital A/c	Dr.	5,000	
To A's Capital A/c			10,000

Alternatively it is possible to account for the increase in the value of assets or decrease in the value of liabilities by debiting the appropriate asset account or liability account and crediting Partners' Capital Accounts at the existing profit sharing ratio. Simultaneously the partners' Capital Accounts are to be debited for such gain in the new profit sharing ratio and the respective asset's/liabilitie's account is to be credited again. So the following journal entries are necessary for ₹ 10,000 increase in sundry fixed assets and ₹ 2,000 decrease in Trade payables :

			₹	₹
(1)	Sundry Fixed Assets A/c	Dr.	10,000	
	Trade payables A/c	Dr.	2,000	
	To A's Capital A/c			4,000
	To B's Capital A/c			4,000
	To C's Capital A/c			4,000
	(Distribution of Revaluation Profit amongst the existing partners at the profit sharing ratio)			
(2)	B's Capital A/c	Dr.	6,000	
	C's Capital A/c	Dr.	6,000	
	To Sundry Fixed Assets A/c			10,000
	To Trade payables A/c			2,000

In this case it is not necessary to open a separate Revaluation Account.

On the retirement of a partner, any undistributed profit or reserve standing at the Balance Sheet is to be credited to the Partners' Capital Accounts in the old profit sharing ratio. Alternatively, only the retiring partner's share may be transferred to his Capital Account if the others continue at the same profit sharing ratio.

For example, A, B and C were in partnership sharing profits and losses at the ratio of 5:3:2. A retired and B and C agreed to share profit and loss at the ratio 3:2. Reserve balance was ₹ 10,000. In this case either of the following two (any one) journal entries can be passed :

		₹	₹
Reserves A/c	Dr.	10,000	
To A's Capital A/c			5,000

To B's Capital A/c			3,000
To C's Capital A/c			2,000
(Transfer of reserve A/c to partners' capital A/cs in 5:3:2 ratio on A's retirement)			
Or			
Reserves A/c	Dr.	5,000	
To A's Capital A/c			5,000
(Transfer of A's share of reserve to his Capital Account on his retirement)			

Note that second alternative has the same implications because B and C continued at the same ratio 3:2 as they did before A's retirement.

Take another example: X, Y, and Z were equal partners. Z decided to retire. X and Y decided to continue in the ratio 3:2. Reserve standing at the date of retirement of Z was ₹ 9,000. In this case adjustment of Z's share was not sufficient since the relationship between X and Y was also changed.

X's gain : $\frac{3}{5}-\frac{1}{3}=\frac{9-5}{15}=\frac{4}{15}$

Y's gain : $\frac{2}{5}-\frac{1}{3}=\frac{6-5}{15}=\frac{1}{15}$

Gaining Ratio : X : Y

4 : 1

This is different from 1:1. So first alternative is to be followed in this case.

		₹	₹
Reserve A/c	Dr.	9,000	
To X's Capital A/c			3,000
To Y's Capital A/c			3,000
To Z's Capital A/c			3,000
(Transfer of Reserve on Z's retirement)			

If the continuing partners want to show reserve in the Balance Sheet, the journal entry will be :

		₹	₹
X's Capital A/c	Dr.	2,400	
Y's Capital A/c	Dr.	600	
To Z's capital A/c			3,000
(Adjustment entry for Z's share of reserve)			

7.1 Final payment to retiring partner

The following adjustments are necessary in the Capital Accounts :

(i) Transfer of reserve

(ii) Transfer of goodwill

(iii) Transfer of profit/loss on revaluation.

After adjustment of the above mentioned items, the Capital Account balance standing to the credit of the retiring partner represents amount to be paid to him.

The continuing partners may discharge the whole claim at the time of retirement. Then the journal entry will appear as follows :

Retiring Partner's Capital A/c	Dr.
To Bank A/c	

Sometimes the retiring partner agrees to retain some portion of his claim in the partnership as loan. The journal entry will be as follows :

Retiring Partner's Capital A/c	Dr.
To Retiring Partners' Loan A/c	
To Bank A/c	

7.2 Liability of Retiring partner

In the absence of an agreement, the retiring partner or the representative of a deceased partner can recover his share in the partnership assets (including goodwill), after having them revalued on a proper basis as at the date of his ceasing to be a partner; appreciation or depreciation determined on such a revaluation is adjusted in his account before the amount due to him is paid.

The amount due to the retiring partner is liability of the firm except where a partnership agreement provides that upon the retirement or death of a partner his share in the assets of the firm will be taken over by the continuing partners in the proportion in which they were sharing the profits or losses of the firm. When the continuing partners take over the assets they also become personally liable to repay the amount due to the retiring partner.

Often the retiring partner's claim is not fully paid but kept in the business as loan. As per arrangement such loan is repaid by instalments alongwith agreed interest. Sometimes joint life policy is taken to meet the claim of the retiring partner.

Points to be remembered :

(1) Retiring partner or the estate of the deceased partner is liable for the whole of the debts due by the firm at the date of retirement or death though, as between the partners they are responsible to pay only their respective share of liabilities [Section 42(2) of the Partnership Act].

(2) Retiring partner may also be held liable for debts contracted after his retirement, unless a

notice of retirement is published as contemplated by the Law [Section 32(2) of the Partnership Act]; and

(3) The estate of a deceased or a bankrupt partner cannot be held liable for debts contracted by the firm after the death or bankruptcy, as the case may be. [Sections 34(2) and 35 of the Partnership Act].

8. Joint Life Policy

A partnership firm may decide to take a Joint Life Insurance Policy on the lives of all partners. The firm pays the premium and the amount of policy is payable to the firm on the death of any partner or on the maturity of policy whichever is earlier. The objective of taking such a policy is to minimise the financial hardships to the event of payment of a large sum to the legal representatives of a deceased partner or to the retiring partner.

The accounting treatment for the premium paid and the Joint Life Policy may be in any of the following ways:

1. **When premium paid is treated as an expense:** When premium is treated as an expense then it is closed every year by transferring to profit and loss account. In this case complete amount received from the insurance company either on a surrender of policy or on the death of the partner becomes a gain.

Accounting entries are:

(a) On payment of premium

Joint Life Policy Insurance Premium A/c Dr.

To Bank A/c

(b) On charging to Profit and Loss Account

Profit and Loss Account Dr.

To Joint Life Policy Insurance Premium A/c

(c) On maturity of the Policy

Insurance Company/ Bank Account Dr.

To Partners' Capital A/cs (individually)

(Including the account of the representative

of a deceased partner)

2. **When premium paid is treated as an asset:** In this case insurance premium paid is first debited to life policy account and credited to bank account. At the end of the year the amount in excess of surrender value is treated as a loss and is transferred to Profit and Loss Account. In this case the amount received from the insurance company in excess of the surrender value

results in a gain at the time of receipt of such amount which is transferred to Capital Accounts of the partners in the profit sharing ratio.

3. **Creation of Joint Policy Reserve Account:** Under this method, premium paid is debited to policy account and credited to bank account. At the end of the year, amount equal to premium is transferred from Profit and Loss Appropriation Account to Policy Reserve Account. After this, policy account is brought down to its surrender value by debiting the life policy reserve account with amount which exceeds the surrender value of the policy. Thus, in this method, policy account appears on the assets side and policy reserve account appears on the liabilities side of the Balance Sheet until it is realised. Both these accounts appear in the Balance Sheet at the surrender value of the policy. This method is different from the method discussed in (2) above only in respect of reserve account.

On the death of a partner Joint Life Policy Reserve Account is transferred to Joint Life Policy Account and then the balance is transferred to Partners' Capital Accounts.

Example

A, B and C are in partnership sharing profits and losses at the ratio of 5 : 3 : 2. The balance sheet of the firm on 31.12.2014 was as follows:

Balance Sheet

Liabilities	*₹*	*Assets*	*₹*
Capital A/cs		*Sundry Fixed Assets*	*80,000*
A	*50,000*	*Inventories*	*50,000*
B	*40,000*	*Trade receivables*	*30,000*
C	*30,000*	*Joint Life Policy*	*20,000*
Bank Loan	*40,000*	*Bank*	*10,000*
Trade payables	*30,000*		
	1,90,000		*1,90,000*

On 1.1.2015, A wants to retire, B and C agreed to continue at 2:1. Joint Life Policy was taken on 1.1.2009 for ₹ 1,00,000 and its surrender value as on 31.12.2014 was ₹ 25,000. For the purpose of A's retirement goodwill was raised for ₹ 1,00,000. Sundry Fixed Assets was revalued for ₹ 1,10,000. But B and C did not prefer to show such increase in assets in the Balance Sheet. Also they agreed to bring necessary cash to discharge 50% of the A's claim, to make the bank balance ₹ 25,000 and to make their capital proportionate.

Prepare necessary journal entries.

Solution

Journal Entries

			₹	₹
1.	B's Capital A/c	Dr.	49,500	
	C's Capital A/c	Dr.	18,000	
	To A's Capital A/c			67,500
	(Share of revaluation profit ₹ 67,500 including good will due to A borne by B and C at the gaining ratio 11 : 4)			
2.	A's Capital A/c	Dr.	1,17,500	
	To A's Loan A/c			58,750
	To Bank A/c			58,750
	(Settlement of A's claim on his retirement by payment of 50% in case and transferring the balance to his Loan A/c).			
3.	Bank A/c	Dr.	73,750	
	To A's Capital A/c			60,333
	To A's Capital A/c			13,417
	(Cash brought in by the continuing partners).			

Working Notes :

1. **Revaluation Profit**

	₹
Goodwill	1,00,000
Sundry Fixed Assets	30,000
Joint Life Policy	5,000
	1,35,000

A's Share ₹ 1,35,000 × 5/10 = ₹ 67,500.

2. **Gaining Ratio**

B : 2/3 - 3/10 = 11/30

C : 1/3 - 2/10 = 4/30

Gaining Ratio :	B	:	C
	11	:	4

3. Total Capital

		₹
Assets as per Balance Sheet		1,90,000
Additional Bank Balance		15,000
		2,05,000
Less : Bank Loan	40,000	
Trade Payables	30,000	
A's Loan	58,750	(1,28,750)
		76,250
B's Share		50,833
C's Share		25,417

Illustration 12

F, G and K were partners sharing profit and losses at the 2:2:1. K wants to retire on 31-12-2014. Given below the Balance Sheet of the partnership as well as other information:

Balance Sheet as on 31-12-2014

Liabilities	₹	*Assets*	₹
Capital A/cs:		*Sundry Fixed Assets*	*1,50,000*
F	*1,20,000*	*Inventory*	*50,000*
G	*80,000*	*Trade Receivables*	*70,000*
K	*60,000*	*Bank*	*50,000*
Reserve	*10,000*		
Trade Payables	*50,000*		
	3,20,000		*3,20,000*

F and G agree to share profits and losses at the ratio of 3:2 in future. Value of goodwill is taken to be ₹ 50,000. Sundry Fixed Assets are revalued upward by ₹ 30,000 and inventory by ₹ 10,000. Trade receivables were valued at ₹ 65,000 on 31.12.2014. F and G agree to bring sufficient cash to discharge claim of K and to make their capital proportionate. Also they wanted to maintain ₹ 75,000 bank balance for working capital. However they did not want to show goodwill in the books of accounts. Pass necessary journal entries and draft the Balance Sheet of M/s F and G.

Solution

Journal Entries

	₹	₹
(1) Reserve A/c Dr.	10,000	

	To F's Capital A/c			4,000
	To G's Capital A/c			4,000
	To K's Capital A/c			2,000
	(Transfer of Reserve to Partners' Capital A/cs on K's retirement).			
(2)	Sundry Fixed Assets A/c	Dr.	30,000	
	Inventory A/c	Dr.	10,000	
	To Profit and Loss Adjustment A/c			40,000
	(Increase in the value of Sundry Fixed Assets and Stock recorded).			
(3)	Profit and Loss Adjustment A/c	Dr.	5,000	
	To Trade Receivable A/c			5,000
	(Being loss arising on trade receivables recorded).			
(4)	Profit and Loss Adjustment A/c	Dr.	35,000	
	To F's Capital A/c			14,000
	To G's Capital A/c			14,000
	To K's Capital A/c			7,000
	(Profit on revaluation transferred to Partners' Capital A/cs on K's retirement)			
(5)	F's Capital A/c	Dr.	10,000	
	To K's Capital A/c			10,000
	(Adjusting the share of K in value of goodwill to F)			
(6)	Bank A/c	Dr.	1,04,000	
	To F's Capital A/c			70,000
	To G's Capital A/c			34,000
	(Cash brought in by F and G as per agreement).			
(7)	K's Capital A/c	Dr.	79,000	
	To Bank A/c			79,000
	(Payment made to K on retirement)			

Balance Sheet
(After K's retirement)

Liabilities	₹	*Assets*	₹
Capital A/cs:		Sundry Fixed Assets	1,80,000
F	1,98,000	Inventory	60,000

G	1,32,000	Trade Receivables	65,000
Trade Payables	50,000	Bank	75,000
	3,80,000		3,80,000

Working Notes :

1. Partner's Capital Accounts

	F	G	K		F	G	K
	₹	₹	₹		₹	₹	₹
To K	10,000	-	-	By Balance b/d	1,20,000	80,000	60,000
To Balance c/d	1,28,000	98,000	79,000	By F	-	-	10,000
				By P & L Adj. A/c	14,000	14,000	7,000
	–	–	–	By Reserve	4,000	4,000	2,000
	1,38,000	98,000	79,000		1,38,000	98,000	79,000
To Bank	–	–	79,000	By Balance b/d	1,28,000	98,000	79,000
To Balance c/d	1,98,000	1,32,000	–	By Bank	70,000	34,000	–
	1,98,000	1,32,000	79,000		1,98,000	1,32,000	79,000

2.

Total capital	₹
Sundry Fixed Assets (₹ 1,50,000 + 30,000)	1,80,000
Inventory (₹ 50,000 + ₹ 10,000)	60,000
Trade Receivables	65,000
Bank	75,000
	3,80,000
Less: Trade Payables	(50,000)
	3,30,000
F's Share (₹ 3,30,000 × 3/5)	1,98,000
G's Share (₹ 3,30,000 × 2/5)	1,32,000

3. Bank Account

	₹		₹
To Balance b/d	50,000	By K's capital A/c	79,000
To F's Capital A/c	70,000	By Balance c/d	75,000
To G's Capital A/c	34,000		
	1,54,000		1,54,000

Illustration 13

Glad and Happy, who make up their accounts to 30 September in each year, carried on business in partnership under the firm name of Feelings.

Their partnership agreement provided:

(1) Profits and losses should be shared Glad - two-third and Happy - one-third.

(2) Interest on capital accounts should be allowed at the rate of 6% per annum but no interest should be allowed or charged on current accounts.

(3) On the retirement or admission of a partner:

(i) If the change takes place during any accounting year, such partner's share of profits or losses for the period up to retirement or from admission is to be arrived at by apportionment on a time basis except where otherwise agreed.

(ii) No account for goodwill is to be maintained in the firm's books, any adjusting entries for transactions between the partners being made in their capital accounts.

(iii) Any balance due to an outgoing partner is to carry interest at 8% per annum from the date of his retirement to the date of payment.

Glad retired from the firm on 31st March 2014 and, on the same day, Happy took into partnership Joy, an employee of the firm. It was agreed that the terms of the previous partnership agreement should apply in all respects except that, as from the date, profits or losses are to be shared: Happy - three-fifth, Joy - two-fifth.

The trial balance extracted from the books of the firm as on 30th September 2014 was as follows:

Particulars	₹	₹
Capital Accounts – 30th September 2013		
Glad	-	*8,000*
Happy	-	*6,000*
Current Accounts – 30th September 2013		
Glad	-	*2,400*
Happy	-	*1,600*
Joy – Cash introduced 31st March, 2014	-	*3,000*
Plant and machinery at cost	*14,000*	-
Plant and machinery: Provision for depreciation -30th September, 2013	-	*2,800*
Motor vehicles at cost	*6,200*	-
Motor vehicles: provision for depreciation – 30th September 2013	-	*3,400*
Purchases	*62,000*	-

Inventory – 30th September 2013	*12,400*	*-*
Wages	*14,600*	*-*
Salaries	*10,800*	*-*
Trade Receivable	*4,600*	*-*
Sales	*-*	*96,000*
Expenses	*1,600*	*-*
Trade Payables	*-*	*6,200*
Rent and rates	*1,400*	*-*
Bad debts	*600*	*-*
Balance at bank	*1,200*	*-*
	1,29,400	*1,29,400*

You are given the following further information:

(1) The value of the firm's goodwill as on 31st March 2014 was agreed to be ₹ 12,000.

(2) On 31st March, 2014, Joy had paid Glad ₹ 5,000 on account of the balance due to him on retirement. But no entry had been made in the books in respect of this payment. The balance due to Glad after taking into account this payment remained unpaid as on 30th September, 2014.

(3) Glad on retirement had taken over one of the firm's motor vehicles and it was agreed that he should be charged for it at its written down value on the date of his retirement. The vehicle had cost ₹ 1,400 and up to 30th September, 2013 depreciation of ₹ 625 had been provided on it.

(4) The inventory as on 30th September 2014 was valued at ₹ 14,200.

(5) Partners' drawings which are included in salaries were as follows:

Glad ₹ 1,800; Happy ₹ 2,400; Joy ₹ 900.

(6) Salaries also included ₹ 1,200 paid to Joy prior to his being admitted as a partner and which is to be charged against the half-year profits of the firm ended on 31st March, 2014.

(7) Professional charges of ₹ 250 included in trade expenses are specifically attributable to the second half of the year.

(8) The whole of the charge of ₹ 600 for bad debts related to the period upto 31st March, 2014.

(9) A bad debts provision specifically, attributable to the second half of the year of 5% of the total debtors is to be made as on 30th September 2014.

(10) As on 30th September 2014, rent paid in advance amounted to ₹ 400 and trade expenses accrued amounted to ₹ 180.

(11) Provision is to be made for depreciation on plant and machinery and on motor vehicles at the rates of 10% and 25% per annum respectively, calculated on cost.

You are required to prepare:

(a) The Trading and profit and loss account for the year ended 30th September 2014.

(b) Partner's capital and current accounts for the year ended 30th September 2014; and

(c) The balance sheet as on that date.

Solution:

(a) Trading and Profit and Loss A/c

for the year ended 30th September, 2014

	₹	₹
Sales		96,000
Less: Cost of goods sold:		
Opening Inventory	12,400	
Purchase	62,000	
	74,400	
Less: Closing Inventory	(14,200)	(60,200)
Less: Wages		(14,600)
Gross Profit		21,200

	Half year to 31st March 2014		*Half year to 30th September 2014*	
	₹	₹	₹	₹
Gross profit allocated on time basis		10,600		10,600
Less: Expenses				
Salaries (W.N.1)	3,450		2,250	
Expenses (W.N.2)	765		1,015	
Rent and rates (W.N.3)	500		500	
Bad debts	600		-	
Provision for doubtful debts	-		230	
Depreciation: (W.N.4)				
Plant and machinery	700		700	
Motor vehicles	775		600	
Interest on loan	-	(6,790)	540	(5,835)
		3,810		4,765
Appropriation of profits:				
Interest on Capital:				

Glad	240			
Happy	180	420	84	
Joy			96	180
Remaining profits				
Glad	2,260			
Happy	1,130	3,390	2,751	
Joy			1,834	4,585
		3,810		4,765

(b) Partners' Capital Accounts

	Glad	*Happy*	*Joy*		*Glad*	*Happy*	*Joy*
	₹	₹	₹		₹	₹	₹
To Glad (goodwill)*		3,200	4,800	By Balance b/d	8,000	6,000	
To Glad's Loan A/c	16,000			By Cash			3,000
To Balance c/d		2,800	3,200	By Happy (goodwill)	3,200		
				By Joy (goodwill)	4,800		
				By Cash			5,000
	16,000	6,000	8,000		16,000	6,000	8,000

Partners' Current Accounts

	Glad	*Happy*	*Joy*		*Glad*	*Happy*	*Joy*
	₹	₹	₹		₹	₹	₹
To Car taken over	600	-	-	By Balance b/d	2,400	1,600	
To Drawings	1,800	2,400	900	By Interest on capital	240	264	96
To Transfer to loan account	2,500			By Profit	2,260	3,881	1,834
To Balance c/d		3,345	1,030				
	4,900	5,745	1,930		4,900	5,745	1,930

(c) Balance Sheet as at 30th September 2014

Assets	*Cost*	*Depreciation*	*Net*
	₹	₹	₹
Fixed assets:			
Plant and machinery	14,000	4,200	9,800
Motor vehicles	4,800	3,975	825
	18,800	8,175	10,625
Other assets:			
Inventory		14,200	

* Goodwill will be credited to Glad for his share and Joy and Happy will be debited in their gaining ratio of 3:2.

Trade Receivables		4,370	
Prepaid Rent		400	
Balance at bank		1,200	
		20,170	
Less: Liabilities			
Outstanding Trade expenses		(180)	
Trade payables		(6,200)	
			13,790
			24,415
Financed by	*Happy* ₹	*Joy* ₹	*Total* ₹
Capital accounts	2,800	3,200	6,000
Current accounts	3,345	1,030	4,375
Loan – Glad			14,040
			24,415

Working Notes

		₹	₹
1.	**Salaries**		
	Total as per trial balance		10,800
	Less: Partners' Drawings - Glad	1,800	
	Happy	2,400	
	Joy	900	(5,100)
			5,700
	Allocation		
	Half-year to 31st March, 2014:		
	½ × (₹ 5,700 – ₹ 1,200) + Joy's salary of ₹ 1,200		3,450
	Half-year to 30 September 2014:		
	½ × (₹ 5,700 – ₹ 1,200)		2,250
			5,700
2.	**Expenses**		
	Total as per trial balance		1,600
	Add: Accrual		180
			1,780
	Allocation		
	Half-year to 31 March 2014:		
	½ × (₹ 1,780 – ₹ 250)		765
	Half-year to 30th September 2014:		
	½ × (₹ 1,780 – ₹ 250) + professional charges of ₹ 250		1,015
			1,780

3.	**Rent and rates**		
	Total as per trial balance		1,400
	Less: Rent paid in advance		(400)
	Allocation: 50 : 50		1,000

4. **Depreciation**
Plant and machinery:
10% per annum on ₹ 14,000 = ₹ 1,400; Allocated 50:50
Motor vehicles:
Half-year to 31st March 2014: 25% per annum on ₹ 6,200 = ₹ 775
Half-year to 30th September 2014: 25% per annum on ₹ 4,800 = ₹ 600

5. **Glad's Loan Account**

	₹		₹
To Cash from Joy	5,000	By Transfer from capital account	16,000
To Balance c/d	14,040	By Transfer from current account	2,500
		By Profit and loss account:	
		Interest at 8% p.a. on	
		₹ 13,500 for six months	540
	19,040		19,040
		By Balance b/d	14,040

		₹	₹
6.	**Car taken over by Glad**		
	Cost		1,400
	Depreciation – upto 30th September 2013	625	
	upto 31st March, 2014	175	800
			600
7.	**Motor vehicles**	*Cost*	*Depreciation*
	Per trial balance	6,200	3,400
	Less: Vehicle sold	(1,400)	(800)
		4,800	2,600
	Charge for year to 30th September 2014		1,375
			3,975
8.	**Trade Receivables**		
	Balance per trial balance		4,600
	Less: Provision for bad debts		(230)
			4,370

9. Death of a Partner

The problems arising on the death of a partner are similar to those arising on retirement. Assets and liabilities have to be revalued and the resultant profit or loss has to be transferred to the Capital Accounts of all partners including the deceased partner.

Goodwill is dealt with exactly in the way already discussed in the case of retirement. The only additional point is that as death may occur on any day, the representatives of the deceased partner will be entitled to the partner's share of profit from the beginning of the year to the date of death. After ascertaining the amount due to the deceased partner, it should be credited to his Executor's Account.

The amount due to the deceased partner carries interest at the mutually agreed upon rate. In the absence of agreement, the representatives of the deceased partner can receive, at their option, interest at the rate of 6% per annum or the share of profit earned for the amount due to the deceased partner.

The basic distinction between retirement and death of a partner relates to finalisation of amount payable to the Executor of the deceased partner. Although revaluation of goodwill is done in the same way as it has been done in case of retirement, in addition, the executor of the deceased partner is entitled to share of profit upto the date of death.

For example, A, B and C are in partnership sharing profits and losses at the ratio of 2:2:1. A died on 15th April, 2015. The firm closes its books of account as on 31st December every year. So the executor of A is entitled for 3½ months profit. If A's share is immediately paid off, then profit for 2014 can be taken as base for calculating 3½ months profit in 2015. If M/s. A, B & C earned ₹ 96,000 in 2014, then 3½ months profit is ₹ 28,000. A's share comes to ₹ 28,000 × 2/5 *i.e.,* ₹ 11,200.

Journal entry is :

Profit and Loss Suspense A/c	Dr.	₹ 11,200	
To A's Capital A/c			₹ 11,200
(Share of A in 3½ months profit in 2015 is transferred to his Capital Account on death)			

10. Special Transactions in case of Death : Joint Life Policy and Separate Life Policy

If Joint Life Policy appears in the Balance Sheet at surrender value, then the firm will gain on the death of a partner. For example, A, B and C are in partnership sharing profits and losses at the ratio of 5:3:2. They took a Joint Life Policy of ₹ 1,00,000 which is appearing in the Balance Sheet at the surrender value of ₹ 10,000,. Now, if A dies, the firm will receive ₹ 1,00,000 from the insurance company.

The journal entries will appear as follows:

			₹	₹
(i)	Bank A/c	Dr.	1,00,000	
	To Joint Life Policy A/c			1,00,000
	(Policy value received from the insurance company on A's death)			
(ii)	Joint Life Policy A/c	Dr.	90,000	
	To A's Capital A/c			45,000
	To B's Capital A/c			27,000
	To C's Capital A/c			18,000

However, if joint life policy does not appear in the Balance Sheet, then entry (ii) is to be passed for ₹ 1,00,000 and it would appear as follows :

Joint Life Policy A/cs	Dr.	1,00,000	
To A's Capital A/c			50,000
To B's Capital A/c			30,000
To C's Capital A/c			20,000

In the event of death of a partner, the policy of the deceased partner will get mature and the firm will receive the assured value of the policy. In this case, the legal representative of the deceased partner is entitled to get the proportionate share of (a) assured value of the matured policy of the deceased partner (b) surrender values of other life policies of the remaining partners taken by the firm.

Bank A/c Dr. (Assured value)

To Separate Life Policy of Deceased partner A/c

(Policy value received on death of a partner)

Separate Life Policy of Deceased Partner A/c Dr. (Assured value)

Separate Life Policy of Remaining Partners A/c Dr (Surrender value)

To Executor's A/c (Total value distributed in profit sharing ratio)

To Remaining partners A/c (Total value distributed in profit sharing ratio)

(Being the total of assured value of deceased partner's life policy and surrender value of other partners' life policy(s) distributed in the profit and loss sharing ratio)

11. Right of Outgoing Partner in Certain Cases to Share Subsequent Profits

As per provisions of Section 37 of the Indian Partnership Act., "Where any member of a firm has died or otherwise ceased to be a partner, and the surviving or continuing partners carry on the business of the firm with the property of the firm without any final settlement of accounts as between them and the outgoing partner or his estate, then, in the absence of a contract to the contrary, the outgoing partner or his estate is entitled at the option of himself or his representatives to such share of the profits made since he ceased to be a partner as may be attributable to the use of his share of the property of the firm or to interest at the rate of six per cent per annum on the amount of his share in the property of the firm.

Provided that whereby contract between the partners an option is given to surviving or continuing partners to purchase the interest of a deceased or outgoing partner, and that option is duly exercised, the estate of the deceased partner, or the outgoing partner or his estate, as the case may be, is not entitled to any further or other share of profits; but if any partner assuming to act in exercise of the option does not in all material respects comply with the terms thereof, he is liable to account under the foregoing provisions of this section. This way, the outgoing partner has the option to receive, interest at the rate of 6% p.a. or the share of profit earned on the unsettled amounts for the period till his dues are settled by the firm in the absence of any contract made to the contrary".

It may be noted that the outgoing partner is not bound to make election until the share of the profit that would be payable to him has been ascertained.

For example, A, B and C are in a partnership business-sharing profits and losses equally. C retires on 31st October, 2014. The capitals of the partners, after all necessary adjustments stood at ₹ 50,000, ₹ 75,000 and ₹ 1,20,000 respectively. A and B continued to carry on the business further without settling the accounts of C. Final payment to C is made on February 1, 2015. The profit made during the period of three months amounts to ₹ 28,000.

Under Section 37 of the Partnership Act, C can exercise any of the following two options.

(i) Share in subsequent profits of firm:

Profit made—₹ 28,000

C's share – $28{,}000 \times \dfrac{1{,}20{,}000}{2{,}45{,}000}$ = ₹ 13,714

(ii) Interest at 6% p.a.

$1{,}20{,}000 \times \dfrac{6}{100} \times \dfrac{3}{12}$ = ₹ 1,800

Since, (*i*) option is beneficial for C, he will necessarily go for his proportionate share in profits.

Illustration 14

Rohan, Sohan and Mohan were partners sharing profits and losses in the ratio of 2:2:1. Their Balance Sheet as on 1-1-2014 stood as follows :

Liabilities	*₹*	*₹*	*Assets*	*₹*
Capital Accounts :			*Fixed Assets*	*1,00,000*
Rohan	*50,000*		*Inventory*	*25,000*
Sohan	*40,000*		*Trade Receivable*	*35,000*
Mohan	*30,000*	*1,20,000*	*Cash and bank*	*10,000*
Reserves		*10,000*		
Trade Payables		*40,000*		
		1,70,000		*1,70,000*

On 1st July, 2014 Mohan died. His representatives agreed that :

(i) Goodwill of the firm be valued at ₹ 50,000;

(ii) Fixed Assets be written down by ₹ 10,000; and

(iii) In lieu of profits, Mohan should be paid at the rate of 25% per annum on his capital as on 1-1-2014.

Current years (2014) profit after charging depreciation of ₹ 9,500 (₹ 5,000 related to the 1st half) was ₹ 40,500. The year-end figures of Inventory, Trade receivables and Trade payables and Cash and Bank Balances were respectively ₹ 23,000, 19,000, 35,000 and 4,377. The particulars regarding their drawings are given below:

	Upto1-7-2014	*After 1-7-2014*
	₹	*₹*
Rohan	*4,125*	*5,000*
Sohan	*4,125*	*5,000*
Mohan	*1,750*	

Prepare the balance sheet of the firm as on 31st December, 2014 assuming, that final settlement to Mohan's executors was made on 31st December, 2014.

Solution

		₹
(a)	Profit after Depreciation	40,500
	Add : Depreciation	9,500
	Profit before Depreciation	50,000
(b)	Profit for the 1st half (assumed : evenly spread)	25,000

	Less : Depreciation with respect to 1st half	(5,000)
	Post Depreciation profit	20,000
(c)	Profit for the 2nd half	25,000
	Less : Depreciation for the 2nd half	(4,500)
	2nd half profit after Depreciation	20,500

(d) **Profit and Loss Appropriation A/c (for the first half)**

	Dr.	₹	₹		*Cr.* ₹
To	Interest on Mohan's Capital (30,000 × 25% for 6 months)		3,750	By Profit	20,000
To	Rohan	8,125			
	Sohan	8,125	16,250		
			20,000		20,000

(e) **Capital Account as on 1-7-2014**

	Rohan	Sohan	Mohan		Rohan	Sohan	Mohan
To Revaluation Loss				By Balance b/d	50,000	40,000	30,000
of Fixed Assets	4,000	4,000	2,000	By Reserves	4,000	4,000	2,000
To Drawings	4,125	4,125	1,750	By Rohan &			
To Mohan	5,000	5,000	—	Sohan (goodwill adj.)	—	—	10,000
To Executor's A/c	–	–	42,000	By Profit and Loss			
To Balance c/d	49,000	39,000	–	Appn. A/c	8,125	8,125	3,750
	62,125	52,125	45,750		62,125	52,125	45,750

(f) **Application of Section 37 of the Partnership Act**

Either

(i) Interest of 42,000 $\times \frac{6}{100} \times \frac{6}{12}$ = ₹ 1,260

Or

(ii) Profit earned out of unsettled capital

$$20,500 \times \frac{42,000}{(49,000 + 39,000 + 42,000)} = ₹\ 6,623$$

(g) In the absence of specific agreement amongst partners on the above subject matter, the representatives of the deceased partner can receive at their option, interest at the rate of 6% p.a. or the share of profit earned for the amount due to the decease partner.

In the above case, it would be rational to assume that the representatives would opt for ₹ 6,623.

(h) **Profit and Loss Appropriation A/c for the second half**

Dr.				Cr.
		₹		₹
To Executors A/c		6,623	By Net Profit	20,500
To Rohan	6,938			
Sohan	6,939	13,877		
		20,500		20,500

(i) **Capital Accounts as on 31-12-2014**

Dr.	Rohan ₹	Sohan ₹	Cr.	Rohan ₹	Sohan ₹
To Drawings	5,000	5,000	By Balance b/d	49,000	39,000
To Balance c/d	50,938	40,939	By Profit & Loss Appn. A/c	6,938	6,939
	55,938	45,939		55,938	45,939

(j) **Executors Account**

Dr.	₹	Cr.	₹
To Bank	48,623	By Mohan's Capital A/c	42,000
		By Profit & Loss Appn. A/c	6,623
	48,623		48,623

(k) **Balance Sheet as on 31-12-2014**

Liabilities	₹	₹	*Assets*	₹	₹
Capital Accounts			Fixed Assets	1,00,000	
Rohan	50,938		*Less* : Written down	(10,000)	
Sohan	40,939	91,877		90,000	
Trade Payables		35,000	*Less* : Depreciation	(9,500)	80,500
			Trade Receivables		19,000
			Inventory		23,000
			Cash and Bank		4,377
		1,26,877			1,26,877

Summary

- **Partnership** is defined as the relationship between persons who have agreed to share the profit or loss of a business carried on by all or any of them acting for all.
- **Two methods of accounting**
  - ✓ Fixed capital method
  - ✓ Fluctuating capital method.
- **Goodwill** is the value of reputation of a firm in respect of profits expected in future over and above the normal rate of profits.
- **Necessity for valuation of goodwill in a firm arises in the following cases:**
  - ✓ When the profit sharing ratio amongst the partners is changed;
  - ✓ When a new partner is admitted;
  - ✓ When a partner retires or dies, and
  - ✓ When the business is dissolved or sold.
- **Methods for valuation of goodwill**:-

  (1) Average profit basis :

  $$\text{Average Profit} = \frac{\text{Total profit}}{\text{Number of Years}}$$

  Goodwill = Average Profit x No. of Years' purchased

  The profits taken into consideration are adjusted with abnormal losses, abnormal gains, return on non-trade investments and errors.

  (2) Super profit basis :

  Calculate Capital Employed

  Assets …….

  Less: Liability …….

  Capital Employed ……..

  - ✓ Find the normal Rate of Return(NRR)
  - ✓ Find Normal Profit=Capital Employed X Normal rate of Return
  - ✓ Find Average Actual Profit
  - ✓ Find Super Profit=Average Actual Profit-Normal Profit
  - ✓ Find Goodwill=Super Profit X Number of Years Purchased

  (3) Annuity basis :

  Goodwill=Super Profit x Annuity Number

  (4) Capitalization basis:

  $$\text{Goodwill} = \frac{\text{Super profit}}{\text{Normal Rate of Return}}$$